Volume II Issue VI

Fade-Self… One Trader's Commentary

Strategy **March 17 2006**

"That 70's Newsletter"

"The greatness comes not when things go always good for you. But the greatness comes when you're really tested, when you take some knocks, some disappointments, when sadness comes."
Richard M. Nixon

"I was stoned. It seemed like a good thing to do at the time."
Jim Morrison

The first quote comes from the lessons taught by the second. Our emotions cause us to make mistakes and if we're intelligent our logic helps us to reconcile them. Like I always say- this newsletter must be enjoyable to read in order to be helpful. Let's face it there is a lot of useful information in almanacs, dictionaries, and desk reference books (my personal favorites)- but people actually read Dan Brown and John Grisham – not Webster's dictionary. So, I like to have fun with this newsletter. What's more fun than the 70's? Nixon took us off the gold standard, OPEC developed an attitude, and Travolta was more than Pulp Fiction. So, the theme this week is going to be a flashback to the 1970's so you'll have some historical perspective to relate today's prices to. There have been significant shifts in price in some markets and others are trading in exactly the same range as they were when we had a former Georgia peanut farmer as President. Historical prices can be especially useful when understanding when you should be focusing on your attention on a commodity sector. This is not necessarily when prices are historically cheap or expensive, but when they are in middle and getting close to reach those levels.

Also, I've been inundated with requests for more specific trade recommendations- so at the end of each section I will give you precisely the trade that you would call your broker with or place online. This will be especially useful for accounts between $10,000 and $50,000 who have a broker ready to place their trades.

Equities- "Didn't exist in the 1970's"

S&P futures contracts didn't begin trading at the Chicago Mercantile Exchange until 1982. However, the stock market did exist. The S&P traded around 25 for much of the decade- compared to 1292 today. The DOW was back around 750. Stock Indices obviously aren't like commodities- so the S&P could still be a bargain up here. I don't think it is, but I also don't think that you can ever be a long term bear in the US stock market. Back on February 13th I wrote that we would likely see a major pullback in the Nasdaq by mid-April. We were sitting at 1653.00 at that point and my level is 1582.00. We dropped as low 1605.00 last week. Here is the chart for the March Nasdaq.

Now, I also showed you how to put on a straddle in the S&P last week. Let's just check on how that trade would be doing. This is how it looked when we put it on.

S&P 500 Straddle Example:
SELL 1 June 1290 Call for 32.25 (x $250 per point)= $8063
SELL 1 June 1290 Put for 30.25 (x $250 per point)= $7562

= Total Value of $15,625

This is how it looks now.
Short 1 June 1290 Call for 32.25 (x $250 per point) currently worth = $8250
Short 1 June 1290 Put for 30.25 (x $250 per point) currently worth = $7250

= Total Value of $15,500

So, the position has decayed $125 in the last week. That's not bad. Of course the S&P could have darted in either direction and increased the overall value- but in this case it didn't. I'd look for this position to continue to decay and I'll keep you updated over time. It's important to consider all of the markets that this strategy could be useful. Specifically, any market that you believe will be without significant trend over the next 40-60 days would be a good candidate for this type of trade. However, it is EVEN MORE IMPORTANT to consider that this is an unlimited risk proposition. Everything seems very simple when the market is going sideways, but what makes this a sophisticated technique is knowing when to pull the plug on the trade. Which isn't quite yet.

Treasuries- "Volcker's Paradise"

For those of you that read this letter regularly- you know how much I admire Paul Volcker and his work in the late 1970's. The 70's were about as wild as the U.S. treasury market ever got. Inflation running rampant combined with inept monetarist policy led for a collision course of two titans. Irrational speculation versus Paul Volcker. It took about three years and short term interest rates as high as 21%, but Volcker ultimately stymied inflation and more importantly inflationary expectations. While I don't think we will ever return to 20%, I do think the long end of the curve will continue to perk up over the next few months. If the June Thirty-Year Bond breaks 109.30- look out below! The hike in U.S. short term rates over the last three years has convinced investors that they should be confident in the economy. I don't know about you, but I'm only confident because rates are higher.

Higher rates mean more foreign investment. Higher rates actually create an environment that is attractive to more conservative investors- as long as the curve isn't steepening. So, if long term rates were rising faster than short term rates (steepening) it would suggest that risk (or perception of risk) in the future is increasing at an increasing rate. If short term rates are being increased (like the last three years) and long term rates were rising at a slower rate (flattening)- it would suggest that confidence (rather than perception of risk) is increasing at an increasing rate. Now, if short term rates and long term rates are increasing at the same rate it simply means that prices are expected to rise due to inflation- but the market has no opinion either way about making new investments.

Trade Recommendations for Treasuries

Call your broker and say:

"I'd like to SELL (X) June E-CBOT Ten-Year Notes @ market. I'd like to place a stop 16 points above entry and an objective 64 points below to buy back."

Or

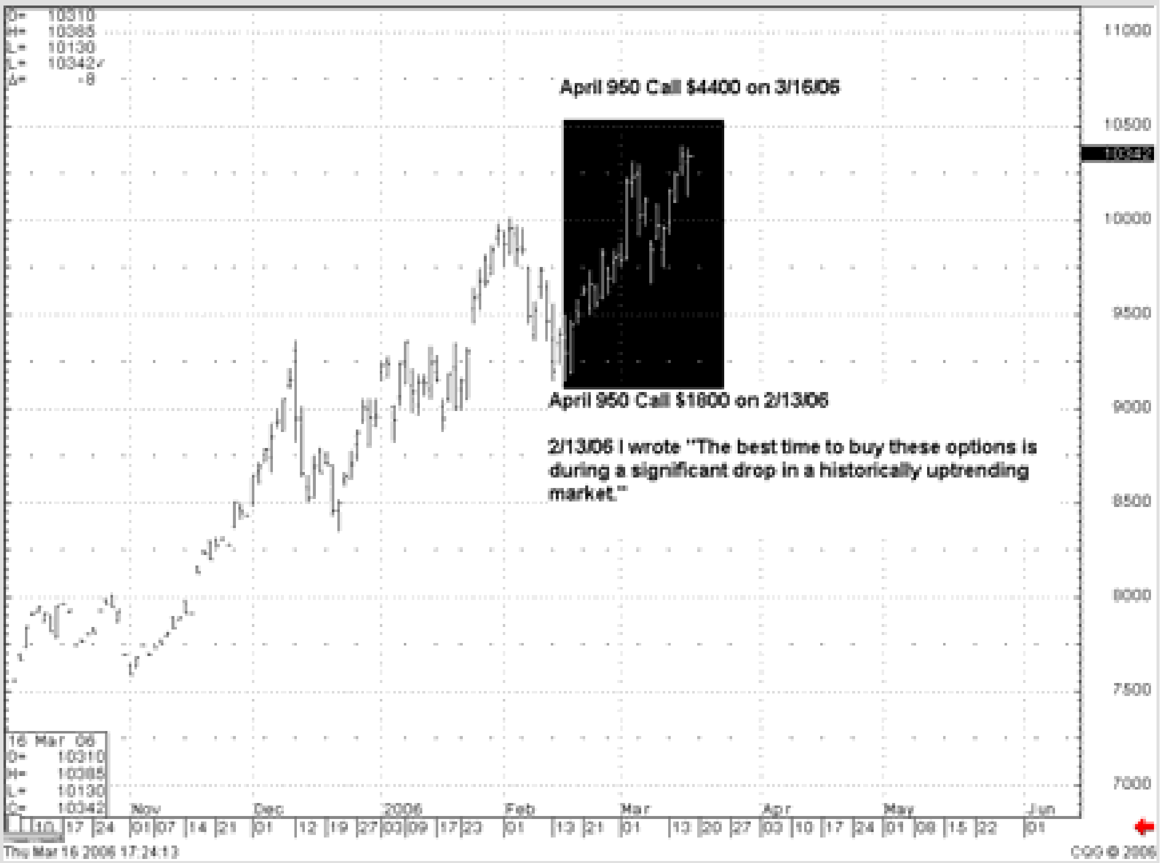
"I'd like to BUY (X) May Thirty-Year Bond 109 Puts @ 12 points."

Metals- "Gold Standard"

It was 1973 and one of America's wealthiest families, the Hunt's, decided that they would begin accumulating silver as a hedge against future inflation. They purchased silver because, at that time it was not legal for a private US citizen to own gold. By 1979 the infamous Hunt brothers had partnered up with some wealthy Arab and created a pool to further accumulate the precious metal. The price of silver skyrocketed from $5.00/oz in early 1979 to a peak of $54.00/oz in February 1980 before falling back to $10.00/oz by April of that year. It started out as pretty good trade for the Hunt's as they began accumulating when the price was $1.95/oz. It finished rather ugly when they lost over a billion dollars and were convicted of attempted market manipulation in 1988. Ouch.

Silver made new 20 year highs yesterday and has been significantly outperforming gold for the last few weeks. Hedge funds continue to maintain larger positions relative to margin in silver than in gold. That's why the move to both the upside and the downside have been so much more exaggerated. I think that Silver is going to go to $100/oz. Ha, ha. Not really. I do think that you don't want to mess with Silver. The last time that we broke $10.00/oz we went to $50.00/oz. The Hunt Brothers aren't around anymore- so we're not likely to double or triple anytime soon, but $15.00/oz should be on your 2006 radar. Silver right now is where Crude Oil was at when it was trading $35.00/barrel. Crude doubled over the following six months.

Doubled. Now there are no guarantees that silver will even increase in value a cent. I think it will. Here is the chart for May silver with the price action since Volume 2 Issue 3 on 2/13/06 inset in black.



<u>Energies- "OPEC RULES"</u>

If you remember sitting in your car in stifling heat waiting in a gas line in the late 1970's- you know what a mess the 70's were politically and economically. Richard Nixon and Arthur Burns (Sect. of Treasury as well as Head of the Fed) were (in my opinion) most responsible for the ruckus and ballyhoo that marred the 70's and made things like the Iran Contra Affair, Gerald Ford (and Disco) possible. Friedman and Monetarism threw a well meaning wrench into the equation. Crude will keep on moving up and probably peter out around $66.08. I'm still convinced that we should stay flat until compelled to get short. The time still isn't quite right. I would suggest to be cool and stay neutral- if you really have to trade energies- try an Iron Condor. Sell $68.00 Calls and $60.00 Puts in the June contract and limit your risk by buying $69.00 Calls and $59.00 Puts. Give us a call for a little more explanation on this strategy

Currencies- "Dudley Moore Was Cool?"

I did some research and found out that Dudley Moore was actually cool in the 1970's. I did see the move "10!", but Bo Derek left more of a burning impression on my mind than good old Dudley. Now I'm thinking, "How do I relate Dudley Moore to currencies." He was British. The British Pound is currently surging versus the dollar. Yeah, that works right? Ok, so the dollar is really breaking this week because it's looking as if the rate hikes are going to pause. This means that the dollar will become less attractive (relatively) to the other major currencies. A truly interesting development was Japan's assertions that they may be leaving the deflationary funk that has weighed on them like a Bootsy Collins base rif. Haha. Now, I don't think that you're going to see anything approaching Funkadelic returns in Japan for another 10 years- but it's not because their economy is not strong (or their currency not worth owning) but because of their proclivity to act provincially when investing. They stay close to home. And they save…A LOT. This is evidenced by the fact that Asian Central Banks own billions upon billions of U.S. Treasury debt.

What does any of this mean for currencies? Good question. In the near term it means a possible trend change in the dollar and an increase in volatility. Back in January (Issue 2.1) I wrote, "The weak dollar trade is going to be THE STORY in 2006-2007. Continuing monetary accommodation, relative to expectations, a still underperforming US economy (relative to China), and lost of spec selling will put the Euro back above 130.00 by the end of this year by mid 2007."

Even earlier, in Volume 1 Issue 18 "The Art of Pugilism" I wrote, "My prediction in the Euro for the end of March is 125.06 and I'll boldface it for effect- **125.06."** Well, the Euro has got the dollar on the ropes like Frazier had Ali in their first bout. But, also like Frazier-Ali there are bound to be rematches between here (122.56) and there. In the mean time you could be buyer of calls in the Euro & the Swissy. An April 123.50 Call in the Euro is currently trading at $625 (22 days to expiration). If you have to buy options I would buy this one at $475 (38 points). As for the Swiss Franc, look at the April 79.00 Call. It's currently trading at $450. My recommendation is to try to buy it for 27 points.

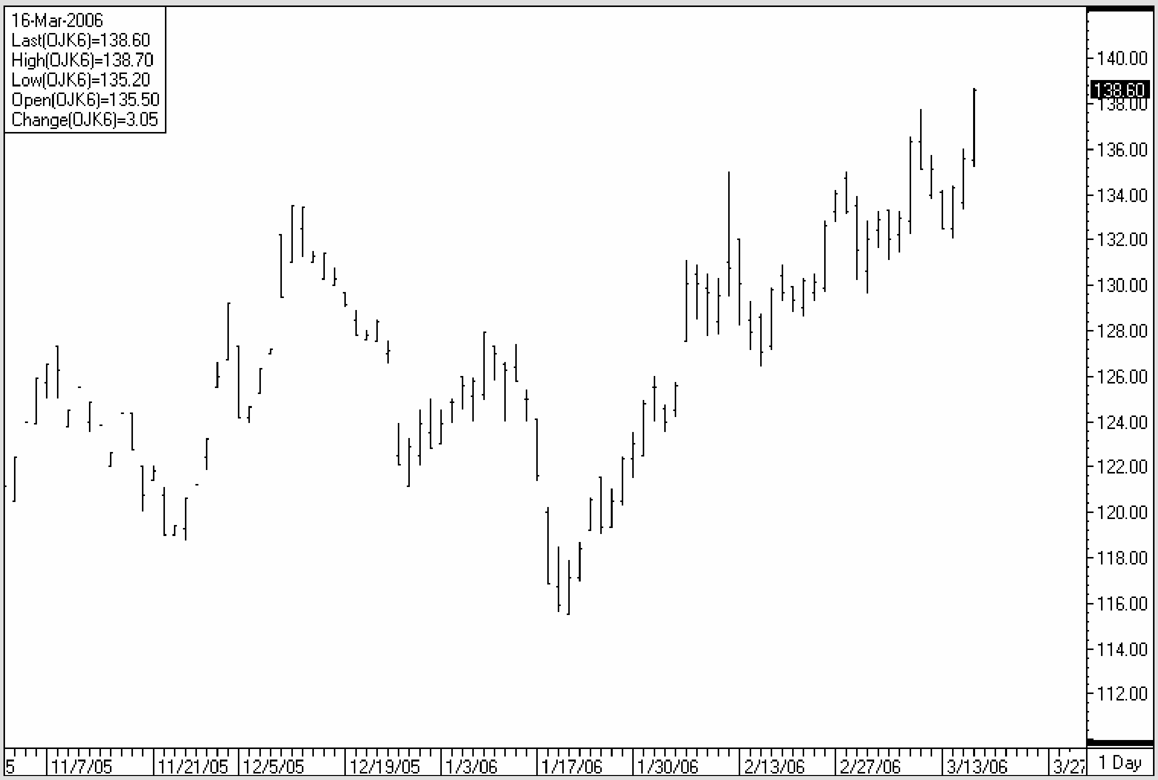
Trade Recommendation's For Currencies:

Call your broker and say:

"I want to BUY (X) April Euro Currency 123.50 Calls at a limit of 38."
"I want to BUY (X) April Swiss Franc 79.00 Calls at a limit of 27."

Traditional Commodities- "Pork Bellies & Orange Juice"

Pork Bellies and FCOJ (Frozen Concentrate Orange Juice) haven't been mainstays in any serious commodity trader's portfolio- since the 1970's. However, check out the OJ charts! Orange Juice has quietly doubled in the last two years. Now, it's a tiny contract and should only be traded if you have traded it before or are in the foods industry. It can really whip around when it gets going and if you succumb to the false sense of security that the tiny margin requirement lulls you into- you could be in trouble. Here is the latest OJ chart:



Trade Recommendation's For Softs:

Call your broker and say:

"I want to BUY (X) May 140.00 Calls at 2.70 points ($405)"

The funds have been easing back their purchases the last week in the grains and it's presenting an ideal opportunity to load up on long positions. This allows you to get strike prices that are very close or even in the money. May Corn 230 Calls (with 36 days to expiration) are currently going for just $250 a piece. May Wheat 360 Calls are going for $650. I would actually place orders to try and pick them up for $450. You could see corn and wheat each rally 30-40 cents in a week at some point this spring- just watch. The May corn call could be worth as much as $1500 before May. But hey they could expire worthless too! The bottom line is that there is an amazing amount of institutional interest in wheat and corn right now. The only thing moderating the rally right now is the lack of export demand. If you couple even the RUMOR of a drought or dry weather with the institutional long position- you'll see fireworks!

Fade-Self (fād-sĕlfˈ) ***verb.***
1. In trading- to take objective conscious action that is directly in opposition to the trader's gut instinct.